U.S. BANKRUPTCY COURT
NORTHERN DISTRICT OF TEXAS
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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
FORT WORTH DIVISION

IN RE:	§	
	§	
ESTILL MEDICAL TECHNOLOGIES, INC.,	§	
	§	CASE NO. 01-48064-DML-11
Debtor.	§	

MEMORANDUM OPINION

Before the court is the claim objection (the "Objection")[1] filed by Estill Medical Technologies, Inc. ("Debtor"). In response to the Objection, Eagle filed its response (the "Response"). After a hearing on the Objection, the court invited the parties to provide supplemental briefs supporting their respective positions. In response, Debtor filed its brief in support of the Objection (the "Support Brief"), Eagle filed its response to the Support Brief (the "Response"), and Debtor filed its reply to the Response (the "Reply"). This matter is subject to the court's core jurisdiction pursuant to 28 U.S.C. §§ 1334(a) and 157(b)(2)(B) & (O). The following comprises the court's findings of fact and conclusions of law. FED. R. BANKR. P. 7052 and 9014.

I. Background

On or about June 15, 1999, Debtor and Eagle entered into an investment agreement (the "Investment Agreement") pursuant to which Debtor and Eagle agreed to subsequently enter into two royalty agreements (the "Royalty Agreements"). According to the Investment Agreement, Eagle agreed to contribute approximately $250,000 to Debtor as consideration for Debtor's grant

1 The Objection was in the form of an omnibus claims objection. The only portion of the Objection treated by this

to Eagle of certain royalty rights and issuance of up to 250,000 shares of Debtor's common stock. On or about June 15, 1999, Debtor and Eagle entered into the first of the Royalty Agreements. In connection therewith, Eagle remitted to Debtor the sum of $100,000 in exchange for 100,000 shares of Debtor's common stock and a royalty interest in patent application number 09/156,324 (the "Patent Application"). The purchase price was allocated $1,000 for the common stock and $99,000 for the royalty interest.[2] On or about July 30, 1999, Debtor and Eagle entered into the second of the Royalty Agreements. In connection therewith, Eagle remitted to Debtor the sum of $150,000 in exchange for 150,000 shares of Debtor's common stock and another royalty interest in the Patent Application. The purchase price was allocated $1,500 for the common stock and $148,500 for the royalty interest.[3] The conveyances of the royalty interests in the Patent Application were filed of record with the United States Department of Commerce, Patent and Trademark Office. Pursuant to the Royalty Agreements, Eagle was to have received $0.20 per Unit[4] (as defined the Royalty Agreements) sold until Eagle received an aggregate of $200,000, and then $0.08 per Unit sold *ad infinitum*. Debtor made royalty payments to Eagle until approximately April 11, 2003.[5]

On November 2, 2001 (the "Petition Date"), Debtor filed a voluntary petition for relief

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Memorandum Opinion is that which applies to the claim of Eagle Equity I, L.P. ("Eagle").

2 Investment Agreement, § 1.1.

3 Id.

4 Debtor designed and produced body fluid warming devices, to which the term "Unit" applied.

5 Eagle Exhibit No. 13.

under chapter 11 of title 11 of the United States Code.[6] In the lists and schedules filed by Debtor in accordance with Section 521(1) and Federal Rule of Bankruptcy Procedure 1007[7], Debtor scheduled Eagle as the holder of a general unsecured claim in the amount of $406 for services as a "Consultant" and also as the holder of 250,208 class C shares of Debtor's stock.[8]

On March 18, 2002, Eagle timely filed an unsecured proof of claim in accordance with the Rules for $406.00, representing royalties earned under Royalty Agreements between May 2001 and the Petition Date (the "Prepetition Royalty Claim").[9] On March 19, 2002, Eagle timely filed an unsecured proof of claim in accordance with the Rules for an "Undetermined" amount for future royalties owed to Eagle under the Royalty Agreements (the "Future Royalty Claim").[10]

On October 31, 2002, Debtor filed its Original Plan of Reorganization (the "Plan"). The Plan proposed to satisfy general unsecured claims by payment of 10% of the allowed amount of such claims over three years in equal quarterly installments, without interest.[11] The Plan proposed to cancel all allowed equity interests in Debtor.[12] The court confirmed the Plan by an order dated February 13, 2003 (the "Confirmation Order"). In the Objection, Debtor objected to

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6 11 U.S.C. § 101 et seq (the "Code"). Hereinafter, all references to "Section" shall refer to the applicable section of the Code.

7 Hereinafter, all references to "Rules" or a "Rule" shall mean, respectively, all or one of the Federal Rules of Bankruptcy Procedure.

8 *See* Debtor's Schedule F and List of Equity Security Holders.

9 *See* Eagle Proof of Claim No. 57, dated March 13, 2002 and filed March 18, 2002.

10 *See* Eagle Proof of Claim No. 61, dated and filed March 19, 2002.

11 *See* Plan, § 4.05.

12 *See* Plan, § 4.07.

the Future Royalty Claim on the basis that it was "a claim for equity contributions" and "should be recharacterized as equity, and cancelled in accordance with the Confirmed Plan."13

II. Discussion

The list of equity security holders filed pursuant to Rule 1007(a)(3) constitutes prima facie evidence of the validity and amount of equity security interests so listed. FED. R. BANKR. P. 3003(b)(2). The schedule of liabilities filed pursuant to Section 521(1) constitutes *prima facie* evidence of the validity and amount of the claims listed, unless such claims are scheduled as disputed, contingent, or unliquidated. FED. R. BANKR. P. 3003(b)(1). A proof of claim filed in accordance with Rule 3003(c) supercedes any scheduling of that claim pursuant to Section 521(1). FED. R. BANKR. P. 3003(c)(4).

A proof of claim executed and filed in accordance with the Rules constitutes prima facie evidence of the validity and amount of the claim. *See* FED. R. BANKR. P. 3001(f). *See also California State Bd. of Equalization v. Official Unsecured Creditors' Committee* (*In the Matter of Fidelity Holding Co. Ltd.*), 837 F.2d 696, 698 (5th Cir. 1988); *Pride Cos. L.P. v. Johnson* (*In re Pride Cos., L.P.*), 285 B.R. 366, 378 (Bankr. N.D. Tex. 2002); *Professional Investors Ins. Group Inc. v. United Overseas Bank* (*In re Professional Investors Ins. Group Inc.*), 232 B.R. 870, 875-76 (Bankr. N.D. Tex. 1999). In order for a claim to be entitled to the weight afforded by Rule 3001(f), it must set forth the facts necessary to support the claim. *See* Collier on Bankruptcy ¶ 3001.09[1] (15th ed. rev. 2003). On the other hand, proofs of claim are not intended to be elaborately detailed documents. As one bankruptcy court has explained, "[a] proof

13 *See* Objection.

of claim for an unsecured creditor requires little more than a listing of name, address, amount of claim (or a listing as "unliquidated" or "contingent"), and a signature. It should take less than five minutes to fill out." *In re Great W. Cities, Inc.*, 88 B.R. 109, 114 (Bankr. N.D. Tex. 1988). In instances when a proof of claim is filed in an "unliquidated" amount, Section 502(c) provides the court with the ability to estimate a claim.[14]

A party objecting to a proof of claim has the burden of going forward and of introducing evidence sufficient to rebut the presumption of validity supplied by Rule 3001(f). *See California State Bd. of Equalization v. Official Unsecured Creditors' Committee* (*In the Matter of Fidelity Holding Co. Ltd.*), 837 F.2d 696, 698 (5th Cir. 1988); *Pride Cos. L.P. v. Johnson* (*In re Pride Cos., L.P.*), 285 B.R. 366, 378 (Bankr. N.D. Tex. 2002); *Professional Investors Ins. Group Inc. v. United Overseas Bank* (*In re Professional Investors Ins. Group Inc.*), 232 B.R. 870, 875-76 (Bankr. N.D. Tex. 1999). Such evidence must be sufficient to demonstrate a true dispute and must have probative force equal to the contents of the claim. *See* Collier on Bankruptcy ¶ 3001.09[2] (15th ed. rev. 2003). Upon introduction of sufficient evidence by the objecting party, the burden of proof will fall on whichever party would bear the burden outside of bankruptcy. *See Raleigh v. Illinois Dep't of Revenue*, 530 U.S. 15, 120 S. Ct. 1951 (2000).

Recharacterization of debt as equity is appropriate where the circumstances show that a debt transaction was "actually [an] equity contribution [] ab initio." *In re Cold Harbor Assocs.*, 204 B.R. 904, 915 (Bankr. E.D. Va. 1997). There is some dispute as to whether bankruptcy

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14 More specifically, Section 502(c) provides: "There shall be estimated for purposes of allowance under [Section 502] . . . any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly

courts have the authority to recharacterize loans as equity. *See Bayer Corp. v. Mascotech, Inc.* (*In re Autostyle Plastics, Inc.*), 269 F.3d 726, 748 (6th Cir. 2001); *Aquino v. Black* (*In re AtlanticRancher, Inc.*), 279 B.R. 411, 413 (Bankr. D. Mass. 2002) (collecting cases and discussing applicable law). *Compare In re Pacific Express, Inc.*, 69 B.R. 112, 115 (9th Cir. B.A.P. 1986) (finding no authority in the Code to allow recharacterization); *In re Pinetree Partners, Ltd.*, 87 B.R. 481, 491 (Bankr. N.D. Ohio 1988) (same), *with In re Cold Harbor Assocs.*, 204 B.R. 904, 915 (Bankr. E.D. Va. 1997) (engaging in recharacterization analysis); *In re Fett Roofing & Sheet Metal Co., Inc.*, 438 F. Supp. 726, 729-30 (Bankr. E.D. Va. 1977) (same). *See also In re Fabricators, Inc.*, 926 F.2d 1458, 1469 (5th Cir. 1991) ("[t]he ability to recharacterize a purported loan emanates from the bankruptcy court's power to ignore the form of a transaction and give effect to its substance."); *Summit Coffee Co. v. Herby's Foods* (*In re Herby's Foods*), 2 F.3d 128, 133 (5th Cir. 1993) (discussing bankruptcy court's ability to recharacterize debt as equity). Those courts deciding that the recharacterization of debt to equity is within a bankruptcy court's sphere of authority have generally relied on Section 105, which states that bankruptcy judges have the authority to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions" of the Code. 11 U.S.C. § 105(a). *See e.g. In re Autostyle Plastics,* 269 F.3d at 748.

In determining whether a loan should be re-characterized as a contribution to capital, relevant factors include:

> (1) the names given to the certificates evidencing the indebtedness;

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delay the administration of the case."

(2) the presence or absence of a fixed maturity date;
(3) the source of payments;
(4) the right to enforce payment of principal and interest;
(5) participation in management flowing as a result;
(6) the status of the contribution in relation to regular corporate creditors;
(7) the intent of the parties;
(8) 'thin' or inadequate capitalization;
(9) identity of interest between creditor and stockholder;
(10) source of interest payments;
(11) the ability of the corporation to obtain loans from outside lending institutions;
(12) the extent to which the advance was used to acquire capital assets; and
(13) the failure of the debtor to repay on the due date or to seek postponement.

See Farr v. Phase-I Molecular Toxicology, Inc. (*In re Phase-I Molecular Toxicology, Inc.*), 287 B.R. 571, 576 (Bankr. D. N.M. 2002); *In re Cold Harbor Associates*, 204 B.R. 904, 915 (Bankr. E.D.Va. 1997) (*quoting Celotex Corp. v. Hillsborough Holdings Corp.* (*In re Hillsborough Holdings Corp.*), 176 B.R. 223, 248 (M.D.Fla. 1994). These factors should be considered in light of the circumstances surrounding each case, with no one factor given controlling or decisive weight. *Farr v. Phase-I Molecular Toxicology, Inc.* (*In re Phase-I Molecular Toxicology, Inc.*), 287 B.R. 571, 576 (Bankr. D. N.M. 2002); *In re Autostyle Plastics, Inc.*, 269 F.3d 726, 750 (6th Cir. 2001) (applying similar factors enunciated in *Roth Steel Tube Co. v. Comm'r of Internal Revenue*, 800 F.2d 625 (6th Cir. 1986), and noting that no one factor is controlling). The party seeking recharacterization of a loan as equity bears the burden of proof. *See Herzog v. Leighton Holdings* (*In re Kids Creek Partners, L.P.*), 212 B.R. 898, 933 (Bankr. N.D. Ill. 1997).

For purposes of this analysis, the court will adopt the view of those courts holding that the recharacterization of debt as equity is within its power. Accordingly, this court will now

attempt to determine whether recharacterization is appropriate in this case.

The threshold inquiry to this determination is what effect, if any, should be ascribed to the parties' actions to this point. First, Debtor scheduled Eagle as both the holder of 250,208 shares of Debtor's stock and the holder of an unsecured claim in the amount of $406. Since Eagle did not file a proof of interest that contradicted Debtor's scheduling of Eagle's equity position and Debtor has not amended its list of equity security holders, the court, based on the *prima facie* evidence produced by that list of equity security holders, finds that Eagle was the holder of 250,208 class C shares of Debtor's stock, which shares were cancelled in accordance with the Plan.

Next, the court considers the Prepetition Royalty Claim. Presumably, the Prepetition Royalty Claim, in the amount of $406.00 (for past due royalties), corresponds with the Debtor's scheduling of Eagle as a general unsecured claimant in the amount of $406.00 (for services as a consultant). The court finds that the information provided by Eagle on the Prepetition Royalty Claim was sufficient to warrant the presumption of validity supplied by Rule 3001(f). Since Debtor has not objected to the Prepetition Royalty Claim, that presumption of validity has not been rebutted and Eagle holds an allowed unsecured claim against Debtor in the amount of $406. On account of that $406 general unsecured claim, Eagle, in accordance with the Plan, is entitled to $40.60 over three years in equal quarterly installments, without interest.

Finally, the court considers the Future Royalty Claim. This proof of claim, while for an "Undetermined" amount, provided sufficient information and substantiation to warrant the presumption of validity supplied by Rule 3001(f). Unlike the Prepetition Royalty Claim,

however, the Future Royalty Claim was subject to an objection by Debtor. Although the Objection itself was not extensive, when taken together with the oral argument presented by Debtor's counsel, it did suffice to rebut the presumption of validity supplied by Rule 3001(f). Therefore, the burden of proof in this case (i.e. whether the advances of funds embodied in the Royalty Agreements should be recharacterized as equity contributions) falls on the party who would bear it outside of bankruptcy (the party advocating recharacterization; in this case, Debtor).

Accordingly, the court must examine whether Debtor has produced enough evidence to justify recharacterization of the claim underlying the Future Royalty Claim. In so doing, the court considers instructive the factors discussed by the *Phase-I Molecular Toxicology, Inc.* court.[15] The names given the documents evidencing the "indebtedness" (e.g. investment agreement and royalty agreements) weigh in favor of the transaction being viewed as a capital contribution. There was no fixed maturity date, which also favors recharacterization. Further, the fact that Eagle was a shareholder in addition to being a supposed creditor similarly favors recharacterization. On the other hand, Debtor produced no evidence that Eagle participated in the management of Debtor as a result of the Royalty Agreements. The evidence elicited at the hearing on the Objection was that, until the Objection was filed, both parties actions were consistent with an intent that the transaction be treated as something other than a capital contribution. Moreover, Debtor did not object to the Prepetition Royalty Claim on the basis that it should have been recharacterized. Since both the Prepetition Royalty Claim and the Future

15 287 B.R. 571, 576 (Bankr. D. N.M. 2002).

Royalty Claim appear to stem from the Royalty Agreements, Debtor's stance with respect to the transaction is, at the least, inconsistent. While it is a close question, the court finds that Debtor has not carried its burden of proving the recharacterization of the claim underlying the Future Royalty Claim is warranted.

As a result, the court finds that Eagle holds a general unsecured claim in an unliquidated amount against Debtor on account of the Future Royalty Claim. Having not been provided with sufficient information to do so, the court is not able, at this time, to estimate the amount of the Future Royalty Claim. The court, therefore, instructs the parties to schedule at the earliest mutually convenient time a hearing at which the court will take evidence in order to estimate the amount of the Future Royalty Claim.

It is so ORDERED.

Signed this the 12 day of September 2003.

DENNIS MICHAEL LYNN
UNITED STATES BANKRUPTCY JUDGE